MANAGERIAL OWNERSHIP, LEVERAGE AND AUDIT QUALITY IMPACT ON FIRM PERFORMANCE: EVIDENCE FROM THE MALAYSIAN ACE MARKET

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ABSTRACT

This paper extends the agency cost literature by examining whether managerial ownership, leverage and audit quality are associated with higher performance of companies traded on the Malaysian ACE (Access, Certainty, Efficiency) Market. The sample consists of 82 companies listed on the Malaysian ACE Market for the period from 2007 to 2009. Analyses of descriptive statistics, correlation analysis, and multiple regressions are used to address the research hypotheses. The descriptive statistics analysis reveals that ACE Market companies do not perform better for the three year test period. This result may explain why the number of listed stocks on the ACE Market decreased from 2006 to 2009. Contrary to the proposed hypotheses, this study finds that audit quality has a statistically significant negative effect on firm performance. The empirical results suggest that higher audit fees received by auditors may create bonding between client and auditors.

JEL: G15, G32, M41

KEYWORDS: Managerial ownership; Leverage; Audit quality; Governance mechanisms; ACE market

INTRODUCTION

A firm's performance represents how effectively managers operate a company and thereby enhance the value of the firm to their shareholders. The relationship between managers and shareholders has raised the issue of a conflict of interest when managers use discretionary power to act in their personal best interest (Jensen & Meckling 1976). To safeguard against such behavior by managers firms need to have control mechanisms to ensure that shareholders' funds are not misappropriated or used for unprofitable activities. That is, firms need to insure that agency costs are minimized.

The relationship between managerial ownership and firm performance proposes that management's ownership in the company would motivate them to act in the best interest of shareholders and thereby reduce agency costs. Leverage can also reduce agency costs since debt holders monitor managers' actions to encourage optimal financial performance. In addition, higher audit fees paid to auditors can either strengthen the economic bond between management and auditors and impair auditor independence resulting in sub-optimal firm performance or increase the level and quality of corporate governance which can enhance the quality of financial statements and increase the efficacy of internal control systems.

A number of studies have examined the relationship between managerial ownership and firm performance, as well as leverage and audit quality and firm performance. These studies have generally focused on firms listed on established exchanges and have found positive relationships exist between managerial ownership, leverage and audit quality with firm performance. In this study we investigate the relationship of managerial ownership, leverage and audit quality on firm performance for firms in the

relatively new and substantially smaller ACE exchange located in Malaysia. The remainder of the paper is organized as follows. Section 2 provides a review of the relevant literature. In section 3 a description of data and methodology are presented. Section 4 provides the results and a discussion of the analysis and Section 5 contains concluding comments.

LITERATURE REVIEW

According to Jensen and Meckling (1976) and Demsetz and Lehn (1985) a high level of managerial ownership may motivate managers to act in the best interest of shareholders and may serve as a positive monitoring substitute to reduce agency conflicts and costs. O'Sullivan and Diacon (2003) looked at board composition and ownership on audit quality for British insurance companies and found the proportion of non-executives directors has a positive impact on audit quality while no relationship was found between Board Chairmen and CEOs ownership and audit quality. Other studies have suggested additional factors that can help explain the relationship between managerial ownership and firm performance including Cui and Mak (2002) who find that industry effects are a factor in the relationship for high R & D firms. In Malaysia, owner-managed companies are common among publicly listed companies.

According to Claessens, *et al.* (2000), at the 20% cut-off of control, about 85% of Malaysian listed companies have owner managers. Leverage is one of the external mechanisms which decision makers believe to be a useful tool to reduce agency costs. Debt holders such as financial institutions and banks will monitor managers' actions to encourage that managers' optimize the financial performance of the firm, Sanda, *et al.* (2005). This external monitoring will allow debt holders to evaluate the eligibility of the firm to receive loans and honor any debt agreements and covenants. In particular, financial leverage will reduce agency costs to shareholders and other stakeholders by having a large creditor monitor managers' performance. Large creditors are normally financial institutions which are stakeholders of the firm in that they have a vested interest in the ability of the firm to continue to make interest payments and repay the loan principal.Financial leverage providers will have an incentive to see that managers take performance-improving measures, Sanda, *et al.* (2005). Thus, as suggested by Jensen (1986) it can be argued that high financial leverage reduces agency costs and improves a firm's financial performance. Several empirical studies support Jensen's assertion. Jensen (1986) highlights the importance of debt in limiting managerial discretion over the use of free cash flow. Sanda, *et al.* (2005) finds that financial leverage has a significant positive influence on overall firm performance in Nigeria, indicating the tendency for firms with higher levels of debt as a proportion of equity to perform better.

Prior studies that looked at the relationship between audit fees and firm performance have shown that higher fees paid to auditors will strengthen the economic bond between management and auditors and impair auditor independence [Ashbaugh, *et al.* (2003), Boylan (2004), and Steven (2007)]. Frankel, *et al. (2002)* provides evidence that the non-audit fees to total fees is positively associated with small earnings surprises and with the magnitude of discretionary accruals while Johnson, Khurana and Reynolds (2002) find that short audit firm tenures are associated with lower quality financial reports. On the other hand, Kinney and Libby (2002) argue that total fees paid to an auditor may increase the economic bond to a client and reduce earnings management by managers. Griffin, *et al.* (2008) examine the audit fee-increasing relationship since auditing services provide one means to increase the level and quality of corporate governance. The authors find that there is a positive relationship between audit fees and the level and quality of corporate governance. This is consistent with the Sarbanes-Oxley (SOX) legislation, which imposed incentives on many companies to strengthen corporate governance, including increased auditing and internal control spending. Hence, even though better corporate governance, including auditing is costly, increased corporate governance may enhance the quality of financial statements and increase the efficacy of internal control systems. This will eventually result in better financial performance of the firm.

DATA AND METHODOLOGY

In this paper we extend the literature by examining whether managerial ownership and audit quality are associated with higher performance of companies traded on the Malaysian ACE (Access, Certainty, Efficiency) market. The establishment of the MESDAQ Market, which changed to the ACE Market in 2009, was to encourage the development of technology based and high growth companies in Malaysia. Companies listed on the ACE Market grew through 2006 but have decreased in 2007 and 2008. Wan Mahmood, *et al.* (2008) suggest that this decrease in listings may be due to investors' perception of the inability of ACE market to perform in the long run which would make it difficult to attract more potential investors Wan Mahmood, *et al*. (2008) find that some ACE firms are under investigation for non-compliance with rules and procedures imposed by Securities Commission. Table 1 presents the total number of listed companies in the Main Market (formerly known as Second and Main Board of Bursa Malaysia) and the ACE Market from years 2002 to 2008. Listings on the Main Board and in the ACE Market rose to a peak in 2006 and fell each subsequent year. .

Table 1: Total Number of Listed Companies in Malaysian Markets

Year	Main Board	Second Board	ACE Market	Total
2008	634	221	122	977
2007	636	227	124	987
2006	649	250	128	1027
2005	646	268	107	1021
2004	622	278	63	963
2003	598	276	32	906
2002	562	294	12	868

The table displays the number of companies listed on the Main Board, Second Board and Ace Market through the years 2002 to 2008. Data was obtained from Bursa Malaysia (As of 21 July 2009).

Table 2 shows the listing requirement changes for the MESDAQ Market and the ACE Market. Listing requirements for the ACE Market are more liberal to attract a broader array of companies. Others reasons forwarded to explain investors leaving the ACE Market include (1.) the belief that the volatile trend of the ACE Market will remain for a period of time unless there are some new regulations by the government to alter the market environment and (2.) the nature of stocks in ACE Market is deemed to be too speculative and high risk. Companies listed on the ACE Market have a higher percentage of civil suits and financial fraud cases compared to companies listed on the Main Market. Clearly this is an indication of poor governance practiced by companies listed on the ACE Market. Motivated by this situation, the current study investigates the relationship between established control mechanisms and performance of companies listed on the ACE Market. This study will focus on established governing mechanisms: managerial ownership, financial leverage, and audit quality, as tools to mitigate agency conflicts.

Table 2: Comparison of the MESDAQ and ACE Markets

Comparing the Old and the New Market	
MESDAQ Market	**ACE Market**
Confined to high-growth or technology-based companies	Allows eligible corporations from all economic sectors
Disallowed if offered for sale	No minimum requirements on operating history, size and track-record
Minimum issue price of 50 cents	No minimum issue price
Other listings – structured warrants allowed	Other listings – structured warrants, SPACS or incubators are not allowed

The table displays the requirements for firms listed on the MESDAQ and Ace Markets. The requirements were obtained from Bursa Malaysia (As of 22nd July 2009). Note: SPACs – Special Purpose Acquisition Companies

The objective of this paper is to examine the relationship between managerial ownership, leverage, and audit quality on firm performance for companies listed on the ACE Market. This study is expected to provide empirical results that will be useful to for regulators such as the Securities Commission, the Bursa Malaysia, and other professional bodies. Regulators and professional bodies may highlight some areas for

improvement and appropriate action should be taken to enhance the quality of governance among the ACE Market companies. Managerial ownership is one of internal mechanisms that govern firm performance. A high level of managerial ownership may motivate managers to act in the best interest of shareholders and may serve as a positive monitoring substitute to reduce agency conflicts and costs, Jensen and Meckling (1976) and Demsetz and Lehn (1985).

Consistent with the above arguments, it is expected that higher managerial ownership levels are associated with better firm performance. Therefore, the following hypothesis will be tested:

$H_{1:}$ There is positive relationship between managerial (insider) ownership and firm performance

Consistent with Jensen (1986), it can be argued that high financial leverage reduces agency costs and improves a firm's financial performance Therefore; the following hypothesis will be tested:

H_2: There is positive relationship between financial leverage and firm performance.

Consistent with the literature on audit quality and firm performance the following hypothesis is tested:

H_3: There is positive relationship between audit quality and firm performance.

Initially, the sample for this study was comprised of all companies listed on the ACE Market of Bursa Malaysia from January 2006 to December 2009. A list of companies listed on the ACE Market was obtained from Bursa Malaysia website (http://www.bursamalaysia.com). Of the 122 companies listed on the ACE Market, 83 companies were initially included in the sample. The remaining listed companies did not provide all of the financial information required for the study. In addition, after the normality of the data had been tested, one company was excluded due to outliers. Therefore, only 82 companies were included in the final sample. This study used two data sources for information. First, the Datastream database was used to provide all types of financial data, assets, and liabilities. Second, data on managerial ownership structure, types of auditor, and audit fees were retrieved from individual company annual reports available through the Bursa Malaysia website. All the annual reports are downloaded through (http://announcements.bursamalaysia.com). Finally, all the necessary data was analyzed using correlation and regression analysis to determine the efficacy of the proposed hypotheses

The analysis uses Tobin's Q (Q-Ratio) as a measure of firm performance. Tobin's Q for the combined market value of all the companies on the stock market should be about equal to their replacement costs, Lindenberg and Ross (1981). In other words, Tobin's Q measures firm performance based on market-value. Following Zunaidah and Fauzias (2008), this study has uses the modified version of Tobin's q ratio as a measure of firm value, calculated as the ratio of sum of market value of equity plus total debt to book value of total assets. In measuring managerial ownership, past research has addressed the agency theory problem concerning the use of managerial (insider) shareholdings [McConnell and Servaes (1990, Yeboah-Duah (1993), Loderer and Martin (1997), Chen, *et al.* (2003), and Florackis, *et al*. (2007)]. However, the empirical results are mixed. In particular, McConnell and Servaes (1990) find a significant curvilinear relationship between insider ownership and firm performance. Loderer and Martin (1997) find no statistically significant relationship between insider ownership and performance. Florackis, *et al.* (2007) report a non-linear relationship between managerial ownership and corporate performance by using a semi-parametric estimation approach, drawing conclusions contrary to those of Yeboah-Duah (1993). In this study, managerial ownership is measured as the total percentage of shares directly held by non-independent executive directors in the company. Following Nazli and Weetman (2006) and Zunaidah and Fauzias (2008), this study does not include shares held by independent non-executive

(outside) directors because the outside directors are expected to play a monitoring role and limit managerial opportunism. Leverage is defined as debt owed to large creditors such as financial institutions.

Leverage has been shown to be a useful tool for mitigating the agency problem. Jensen and Meckling (1976) have identified that financial leverage has a significant impact on financial performance. Financial leverage influences firm performance through monitoring activities by debt holders. Problems of agency theory arise when there is a conflict between the interests of shareholders and the interests of debt holders. Such problems start when the company needs to honor the loan agreement with the debt holder even when the company is not performing well. However, if the company is performing very well, then the shareholders will reap the incremental benefits. Thus, shareholders receive greater benefits than debt holders during period of good financial performance. This study uses total debt divided by total assets to measure financial leverage.The demand for auditing arises as a result from the auditor's monitoring role in the principal-agent relationship, Eilifsen and Messier (2000). Financial reporting or disclosure quality had been measured as one of the mechanism in assessing the corporate governance of a firm, Mitton (2002) and Coles, *et al.* (2001). Auditing is necessary to ensure the financial transparency that provides depositors, creditors and shareholders with credible assurances that the corporate managers will not engage in fraudulent activities. On the other hand, the role of statutory auditors and the demand for audit quality are influenced by corporate governance characteristics and the legal system of investor protection, Piot (2001). As summarized in De Fond (1992), past studies have shown that the demand for audit quality is a function of the agency conflict caused by the disparity between management and ownership incentives. Thus, this study will use audit fees as a proxy for audit quality.

Audit fees are defined as the sum of all fees including audit fees and non-audit fees paid to the auditor, Hoistash, *et al*. (2007). Fees include costs for professional audit services as well as non-audit fees charged by the auditor to the client. This approach to measuring audit fees is in accordance with the standards published by the Public Company Accounting Oversight Board, which states that fees for professional services are necessary to perform an audit or review including services rendered for the audit of the company's annual financial statements. This clause extends to the services incurred with rendering an opinion under Section 404 of the Sarbanes-Oxley Act of 2002 and with the review of quarterly financial statements. In addition to the amendments of Corporate Governance, the Securities Commission of Malaysia issues new regulations to all listed companies to disclose audit fees in their annual reports.

In this paper firm size is used as a control variable because empirical studies have shown that firm size is a determinant of firm financial performance. Normally, larger firms are perceived differently by shareholders. For example, there is an assumption that larger firms may pay higher dividends and may have larger boards. This hypothesis supported by Short and Keasey (1999), who report that firm size has a statistically significantly positive effect on financial performance, since larger firms have the potential to access funds with greater ease, both internally and externally. Larger companies also may have better growth opportunities and access to additional financing opportunities. Larger companies are also likely to have greater analyst following, have more information available which reduces information asymmetry, and have wider share ownership and a more extensive ownership profile. Given this, the natural logarithm of the firm's total assets is used to indicate firm size. This measure is consistent with studies which have used total assets to measure firm size, Abdussalam (2006).

Profitability is also used as a control variable. In this study earnings per share (EPS) is used as a measure of a firm's profitability which is consistent with Kumar and Sopariwala (1992), Ahmed and Khababa (1999), Kaufmann, *et al.* (2000), and Al-Malkawi (2005). EPS is considered to be "the market's pre-eminent measure of firm performance," Kaufmann, *et al.* (2000, page 219).Table 3 summarizes the variables used in this study.

Table 3: Summary of Variables and Their Predicted Direction in Relation to Firm Performance

Variable	Measurement	Predicted direction
Dependent Variable		
• Tobin Q (Q-ratio)	$Q_{ratio} = \frac{MVE + TDEBT}{TOTAL\ ASSETS}$	
Independent Variable		
Governance Mechanisms		
• Managerial ownership (MO)	Total percentage of shares directly held by non-independent directors of the company	+
• Leverage (Lev)	Total Debt / Total Assets	+
• Audit Quality (AQ)	The sum of all audit fees paid to the auditor	+
Control Variables		
• Firm size	Natural log of total assets ln(Total Assets)	
• Profitability	Earnings per share (EPS)	

This table shows the dependent and independent variables and how they were measured. The table also displays the predicted direction of the independent variable in relation to the dependent variable.

Consistent with Coakes, Steed and Ong (2009) some variables were transformed to achieve normality. Transformed variables included the Q-ratio, managerial ownership, leverage, total audit fees, and firm size. The remaining variable, profitability, did not need to be transformed.

RESULTS AND DISCUSSION

Table 4 shows the descriptive statistics of the sample selected for the three consecutive years, 2006 to 2008. The sample data were collected for 82 companies listed on the ACE Market. The outliers' consist of data where the log Tobin-Q Ratio is more than 1.2. All of the other variables are in the range of 0.2 to 0.9. Finally, the total number of datum (N) is 246 which are 82 companies over three year.

Table 4: Descriptive Statistics

Statistic	*Tobin-Q Ratio*	*Managerial Ownership*	*Leverage*	*Audit Quality*	*Firm Size*	*Profitability*
Min	0.050	0.000	0.000	0.700	3.420	-0.290
Max	0.880	0.830	0.710	3.110	5.750	0.529
Mean	0.380	0.438	0.252	1.668	4.610	0.005
Median	0.363	0.451	0.248	1.623	4.620	0.007
SD	0.152	0.234	0.189	0.361	0.369	0.066
Skewness	0.513	-0.237	0.318	0.645	0.119	1.433
Kurtosis	0.251	-1.144	-0.903	1.203	1.509	21.083
Number	=	246				

The table shows the descriptive statistics for variables used in this study.

Table 5 shows the correlation coefficients between all of the independent variables and dependent variable and Table 6 summarizes the correlation analysis. Managerial ownership, leverage, total audit fees, and firm size are positively correlated with Q-ratio at significant level of 0.05 for managerial ownership and the rest has significant level of 0.01. On the other hand, there is no significant correlation between the profitability and Q-ratio.

Table 5: Correlation Coefficients

N=246	Q-Ratio	Managerial Ownership	Lev	Tot Audit Fees	Firm Size	Profitability
Q-Ratio	-	0.122*	0.170**	0.268**	0.162**	-0.061
Managerial Ownership		-	0.035	-0.128*	-0.032	-0.045
Leverage			-	0.167**	0.248**	-0.040
Total Audit Fees				-	0.521**	0.109*
Firm Size					-	0.279**
Profitability						-

*The table displays the correlation analysis between variables used in this study and shows a significant relationship between managerial ownership, leverage, audit fees and firm size with Tobin-Q. The asterisks in the table, ** and *, denotes correlation is significant at 0.01 and 0.05 levels (1-tailed), respectively.*

Table 6: Summary Results of Correlation Analysis for Tobin-Q Measurement

Research Hypotheses	Prediction	Result	Hypotheses
There is positive relationship between managerial (insider) ownership and firm performance	Positive	Significant (Positive)	Supported
There is positive relationship between leverage and firm performance	Positive	Significant (Positive)	Supported
There is positive relationship between audit quality and firm performance	Positive	Significant (Positive)	Supported

The table lists the research hypotheses, the prediction of the dependent variable, the results of the correlation and whether the hypotheses were supported.

Multiple regression analysis is one of the parametric techniques that can be applied if the data is assumed to be normally distributed. However, regression analysis is fairly robust for validity against non-normality. Pallant (2007) argues that with a sample size greater than 30, the violation of the normality assumption should not cause any major problems. Based on this argument, a multiple regression analysis as an extension of the correlation is conducted. The main difference between correlation analysis and regression analysis is that, in bivariate correlation, the relationship is only tested between one independent variable and one dependent variable whereas, in multiple regression analysis, more than two independent variables will be tested for their explanatory power against one dependent variable. The regression model is estimated based on three (2) models as follow:

Model 1: Regression analysis of internal governance (managerial ownership)

$$\text{Firm Performance} = \alpha + \beta 1 \text{ Managerial ownership} + € \quad (1)$$

Where: α = intercept term, β_1 = regression coefficient, € = standard error

Model 2: Regression analysis between internal governance and external governance (managerial ownership, leverage, and audit quality)

$$\text{Firm Performance} = \alpha + \beta_1 \text{ Managerial ownership} + \beta_2 \text{ Leverage} + \beta_3 \text{ Audit Quality} + € \quad (2)$$

Where: α = intercept term, β_1 until β_3= regression coefficient, € = standard error

For Model (1), the equation indicates the contribution that internal governance measured by managerial ownership has on firm performance, measured by the Q-ratio. Model (2) measures the contribution that the internal governance variables measured by managerial ownership and external governance measured by financial leverage and audit quality make to the prediction of firm financial performance measured by the Q-ratio. Table 7 reports the hierarchical regression results for managerial ownership, leverage, and audit quality on firm financial performance (Q-ratio) after controlling for the effect of firm size and profitability. Model (1) shows the impact of the internal control mechanism, which is managerial

ownership on firm financial performance. The regression coefficient for firm size is statistically significant at the 1% level and is negative. The regression coefficient for profitability and managerial ownership are not statistically significant. The adjusted in R^2 for the regression is 4.68% and the F-statistic is 4.951 and is statistically significant at the 5% level. This means that 4.68% of the variation in firm's performance is explained by the variation of managerial ownership after controlling for the effect of firm size and profitability, taking into account the sample size and the number of independent variables. Meanwhile, for Model (2), the adjusted in R^2 is 8.1% meaning that 8.1% of the variation of firm financial performance is explained by the internal mechanism, i.e. managerial ownership, and the two external mechanisms, i.e. financial leverage and audit quality, after controlling the effect of firm size and profitability, taking into account the sample size and the number of independent variables.

Table 7: Results of Hierarchical Regression Analyses Examining the Impact of Managerial Ownership, Leverage and Audit Quality on Firm Performance

	DV: Q-Ratio			
Independent Variables	Model 1		Model 2	
	β	*S.E*	*β*	*S.E*
Intercept	1.198***	0.108	1.129***	0.109
Control variable:				
Firm Size	-0.075***	0.023	-0.026	0.027
Profitability	0.196	0.129	0.167	0.128
Internal Mechanisms:				
Managerial Ownership	-0.085	0.042	-0.105	0.041
External Mechanisms:				
Leverage			-.0029	0.044
Audit Quality			-0.087***	0.027
R^2	0.058		0.100	
Adjusted R^2	0.046		0.081	
Change R^2	0.058		0.042	
F-Statistics	4.951**		5.327**	
Df	242, 3		240, 2	

*The table shows that for Model (1) the impact of the internal control mechanism, which is managerial ownership, on firm financial performance. The regression coefficient for firm size is statistically significant at the 1% level and is negative. In Model (2), the regression coefficient for audit quality is statistically significant at the 1% level and is negative. This means that there is a negative relationship between audit quality and firm financial performance for firms listed on the ACE market. Note: The asterisks ***, **, and * denotes significant at 1 per cent (p<0.01), 5 per cent (p<0.05), and 10 per cent (p<0.1) confidence levels, respectively.*

As shown in Model (2), the regression coefficient for audit quality is statistically significant at the 1% level and is negative. This means that there is a negative relationship between audit quality and firm financial performance for firms listed on the ACE market. This is probably due to higher audit fees received by auditors which may create a bonding between clients and auditors. This empirical result is consistent with the empirical results of Hoitash, *et al.* (2007) who finds that economic bonding is a determinant of auditor behavior rather than auditor reputational concerns. However, the regression coefficients for managerial ownership and financial leverage are not statistically significant.

CONCLUDING COMMENTS

In this study we examined the relationship between corporate governance mechanisms such as managerial ownership, leverage, and audit quality and firm financial performance using a sample of 82 companies listed on the ACE Market in Malaysia for the period of 2006, 2007, and 2008. The statistically significant and positive correlation between the three independent variables, managerial ownership, leverage, and audit quality, indicates the importance and impact of these corporate governance mechanisms on firm financial performance. The study provides empirical results that are useful to regulators such as financial institutions, the Securities Commission, and the Bursa Malaysia. Regulators and professional bodies may highlight some areas of improvements and appropriate actions that should be taken in order to enhance the quality of corporate governance mechanisms among ACE market companies. In addition, the Securities Commission can use the empirical results of the current study to develop mechanisms to

facilitate the regulation of corporate managers as a part of the Securities Commission's regulatory responsibilities. For example, the Securities Commission may tighten the regulation of applications for financial sources from the Ministry of Finance, so that if financial assistance is given to a company the money will not be used for the self-interest of management. Furthermore, the current study highlights some of the recommendations to financial institutions for new regulations of the ACE Market.

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